

Passive Investment Companies

PURPOSE: This Special Notice provides guidance regarding the formation and operation of a Passive Investment Company (PIC) in Connecticut.

EFFECTIVE DATE: For income years of the PIC beginning on or after January 1, 1999, and for the income year of the federal consolidated group of which the PIC is a member beginning on or after January 1, 1999.

STATUTORY AUTHORITY: Conn. Gen. Stat. §§12-213, 12-217u, 12-218b, and 12-226a.

RELEVANT DEFINITIONS:

Passive Investment Company means any corporation which is a related person to a financial service company or to an insurance company, and

- Employs not less than five full-time equivalent employees in the state;
- Maintains an office in the state; and
- Confines its activities to the purchase, receipt, maintenance, management and sale of its intangible investments, and the collection and distribution of the income from such investments.

Conn. Gen. Stat. §12-213(a)(27)

Related Person means

- A corporation, limited liability company, partnership, association or trust controlled by the taxpayer;
- An individual, corporation, limited liability company, partnership, association or trust that is in control of the taxpayer;
- A corporation, limited liability company, partnership, association or trust controlled by an individual, corporation, limited liability company, partnership, association or trust that is in control of the taxpayer; or
- A member of the same controlled group as the taxpayer.

Conn. Gen. Stat. §12-218b(a)(18)

Intangible Investments are limited to

- Loans as defined in Conn. Gen. Stat. §12-218b(a)(10) secured by real property, as defined in Conn. Gen. Stat. §12-218b(a)(11), which include a line of credit secured by real property, such as a home equity loan or construction loan, and which permits future advances by the PIC. Mortgage-backed securities, such as collateralized mortgage obligations or interests in real estate mortgage investment conduits, are not loans secured by real property.

- The collateral or an interest in the collateral that secures such loans, if the sale of such collateral or interest is actively marketed by or on behalf of the PIC.
- *Short-term investments of cash* which means any investment with a stated term of less than three months, or that can be converted to cash within three months. For example, funds lodged with or loaned to a related person of the PIC, such as a due to/due from account or sweep account with a related bank, or the investment of escrow accounts established in connection with a loan secured by real property.

For example, stock in a subsidiary is not an intangible investment.

Financial Service Company means

- Any corporation or other business entity registered under the laws of any state as a bank holding company or registered under the federal Bank Holding Company Act of 1956, or registered as a savings and loan holding company under the Federal National Housing Act;
- A national bank organized and existing as a national bank association pursuant to the provisions of the National Bank Act;
- A savings association or federal savings bank as defined in the Federal Deposit Insurance Act;
- Any bank, banking association, trust company, savings and loan association or thrift institution incorporated or organized under the laws of any state, or any other corporation or other business entity, the deposits or accounts of which are insured under the Federal Deposit Insurance Act or by the Federal Deposit Insurance Corporation;
- Any corporation organized under the provisions of 12 USC §§611 to 631;
- Any foreign bank that has an agency or branch, as defined in 12 USC §3101;
- A credit union organized under the laws of any state, the loan assets of which exceed fifty million dollars as of the first day of its income year;
- A production credit association organized under the federal Farm Credit Act of 1933, all of whose stock held by the Federal Production Credit Corporation has been retired;
- Any company whose voting stock is more than 50% owned, directly or indirectly, by any entity listed above, or by an insurance company, other than an insurance company or a company that has more than 50% of its gross income from one or more of the following sources other than from sales to a

related person: manufacturing, construction, mining, transportation, and public utilities, retail or wholesale trade, other than the retail or wholesale delivery of financial services as described below, or agriculture, forestry, and fishing;

- Any company other than an insurance company or a real estate broker, which derives 50% or more of its gross income from one or more of the financial services or activities listed in Conn. Gen. Stat. §12-218b(a)(6)(J)(i), such as loans, letters of credit, underwriting, brokerage of securities, investment advisory or investment banking services, etc.

Conn. Gen. Stat. §12-218b

Insurance Company means any corporation, limited liability company, association, partnership or combination of persons doing any kind or form of insurance business other than a fraternal benefit society. (Conn. Gen. Stat. §12-218b(a)(8))

GENERAL PRINCIPLES: A PIC is not a “Taxpayer” under Conn. Gen. Stat. §12-213(a)(1) and, therefore, is not subject to the Connecticut corporation business tax. In addition, a dividend received, directly or indirectly, from a PIC does not constitute “gross income” within the definition in Conn. Gen. Stat. §12-213(a)(9)(C).

STATUTORY REQUIREMENTS FOR A PIC:

A. A PIC must employ not less than five full-time equivalent employees in Connecticut.

- Full-time employment is based on a 35 hour work week.
- Part-time or dual employees may be used in calculating the number of full-time equivalent employees. The PIC must employ that number of full-time, part-time, and/or dual employees that, when calculating the amount of time such employees work on PIC-related matters, will add up to at least five full-time equivalent employees. In order to eliminate the use of *de minimis* amounts of time, no more than twenty-five (25) employees’ time may be allocated to attain the requisite five full-time equivalent employees of a PIC.
- Safe Harbor Test: In lieu of relying on actual time records maintained throughout the year, taxpayers may use an annual safe-harbor test based on the employees’ time records for either the first month of the taxable year or for an average of the first three months in such taxable year (“the applicable period”). For a PIC’s first taxable year, the applicable period shall be the first 30 days after it begins commercial operations or an average of the first three months after it begins commercial operations. If the time worked on PIC business by the twenty-five (25) or less employees, as determined from their time records during the applicable period, constitutes the equivalent of five full-time employees and the applicable period is representative of its level of employment throughout the year, the PIC may rely on such determination for the entire year. **Form CT-1120 PIC, Information Return for Passive Investment Companies**, enables a PIC to affirm that the applicable period selected is representative of, or generally no less than, its level of employment throughout the year.

- Use of a common paymaster is permitted in accordance with Treas. Reg. §31.3121(s)-1. There shall exist sufficient evidence of employment status if computerized payroll records use a different identifier field to identify full-time or part-time PIC employees or dual employees who are employed by the PIC.

B. A PIC must maintain an office in Connecticut that is either owned or leased.

C. A PIC must confine its activities to the purchase, receipt, maintenance, management and sale of its intangible investments, and the collection and distribution of the income from such investments, including (but not limited to) interest and gains from the sale, transfer or assignment of such investments or from the foreclosure upon or sale, transfer or assignment of the collateral securing such investments.

- **Permitted activities:** Activities related to the transfer of a loan to the PIC, including preparation of transfer documents, assignment of mortgage etc.; loan payment billing, processing and recording activities; responding to loan inquiries; the establishment, review, record-keeping, and management of loan-related escrows (such as escrows for taxes, insurance, etc.), and activities related to the items for which an escrow is maintained (such as obtaining insurance policies and binders, payment of premiums and taxes); review of requests for, and processing of, advances under lines of credit and construction loans held by the PIC, as well as reductions or increases in the amounts permitted to be advanced under such lines of credit and construction loans; review and management of delinquent loans held by the PIC; collection and foreclosure activity associated with loans held by the PIC; maintenance, management, marketing, and sale activities related to foreclosed properties held by the PIC; activities related to the refinancing or restructuring of a loan held by the PIC; bookkeeping, accounting, and auditing activities related to PIC permitted activities, assets and/or intangible investments; operation and management of PIC offices and personnel (such as allocation of time spent relating to PIC personnel matters - hiring, review, firing, benefits, etc. - and the day-to-day operations of the PIC-information systems, furniture, and equipment); maintenance and management of cash investments held by the PIC.

Examples of income that can be earned by a PIC: mortgage interest; points paid in connection with the origination of a loan, to the extent that the points are transferred to the PIC in accordance with Financial Accounting Standards Board 91; gains and losses from sales of PIC loans, sales of the collateral securing such loans, and from the management of collateral that secured a PIC loan while such collateral was held pending a sale.

- **Prohibited activities:** The review and processing of loan applications; the closing of the initial loan; the servicing of loans not held by a PIC; holding a loan solely for the purpose of sale (other than to a related party); provided

however, that any loan which is sold to an unrelated party after being held for 90 days or more from the date of origination shall not be considered a loan held solely for the purpose of the sale; and any other activities which clearly do not constitute permitted activities of a PIC.

- D. **Formation.** A corporation shall qualify as a PIC in its initial year of operation so long as the above-referenced statutory requirements are satisfied as of the beginning of the PIC's commercial operations (which may be after its date of incorporation) and the PIC does not engage in any activities unrelated to its start-up and preparation for operation of a PIC prior to the beginning of commercial operations.
-

OPERATIONAL ISSUES:

A. Allocation of Expenses and Employee Costs

- **General Principles:** PIC-related expenses and costs may be allocated to a PIC on any reasonable basis provided in I.R.C. §482 and the regulations provided thereunder. For example, the taxpayer may use one method to calculate expenses associated with an office used by a PIC, such as rent, utilities, taxes, etc., and another method to determine the employee costs, such as salaries and benefits allocable to the PIC. However, the use of such methods will require the taxpayer to maintain adequate books and records sufficient to permit the Department to verify the allocation of expenses and employee costs to the PIC. (See Treas. Reg. §31.482-2(b)(3).) Such allocation of expenses and costs between the taxpayer and the PIC shall not be subject to Connecticut sales and use taxes.
- **Safe Harbor Elections:** In lieu of using any one of the methods permitted under I.R.C. §482, taxpayers will be allowed to make one of two alternative safe harbor elections on its tax return each year in determining the reasonable allocation of expenses and employee costs to a PIC. The first is the **Percentage of Time Method** and the second is the **Percentage of Loans Method**. Use of either method will protect a taxpayer from adjustments pursuant to Conn. Gen. Stat. §12-226a. However, the method selected for a particular year must be applied consistently to **all** expenses and employee costs on an "all or nothing" basis. For example, a taxpayer may not choose one method for certain expenses and another method for other costs.
- **Percentage of Time:** Under this method, PIC-related expenses and employee costs may be allocated on the basis of the ratio of the number of PIC employees to the total number of employees in the PIC and its related financial service company. The number of PIC employees may be determined either from the employees' time records used in calculating the five full-time equivalent employees under the safe harbor test, or from actual time records for those taxpayers that do not rely on the safe harbor test. However, no employee that expends less than 20% (.20) of his or her time on PIC business shall be included in the calculation of the number of PIC employees for purposes of determining the ratio.

- **Percentage of Loans:** Under this method, PIC-related expenses and employee costs may be allocated on the basis of the ratio of the number of PIC loans to all loans serviced by the PIC and its related financial service company. Such ratio shall be based upon the average number of loans held during the first month of a PIC's taxable year **or** first 30 days after it begins commercial operations for its first taxable year **and** the average number of loans held during the last month of a PIC's taxable year. This method may be used by any entity that employs five or more full-time employees on PIC business without the need to allocate employees' time in order to qualify for PIC status. Under certain circumstances, mortgage loans that would otherwise qualify to be in the PIC might not be transferred to it. For example, mortgage loans that are not transferred to the PIC because of reserve requirements and loans that the taxpayer sells and continues to service would not be included in the number of PIC loans. However, these loans would be included in the total number of loans issued by the taxpayer.

- **Nonallocated expenses:** Certain expenses may not be included in the pool of expenses that will be partially allocated to the PIC under the general principles or safe harbor elections noted above. They are:
 - Interest on borrowings, deposits, and escrows;
 - FDIC insurance premiums; and
 - Investment banking fees relating to mergers, acquisitions and other extraordinary transactions.

B. Pledge to Federal Home Loan Bank

A financial service company may pledge the stock of a PIC and/or the PIC may issue a guarantee, or enter into a suretyship agreement, and/or pledge its assets or loan portfolio to a Federal Home Loan Bank or successor organization ("FHLB") in connection with or to secure any advance made by the FHLB to a related person of the PIC or the PIC itself. And a PIC may execute the Asset Pledge Agreement, Stock Pledge Agreement, and Suretyship Agreement as currently required by the FHLB, as well as any other agreements and/or documents that may be necessary in order to comply with any existing or future FHLB or other requirements related to any advance made or to be made by the FHLB to a related person of the PIC or to the PIC itself.

C. Transfer of Intangible Investments to a PIC

- A financial service company may contribute or otherwise transfer loans to a PIC with a right of recourse against the transferor. Consequently, a loan with recourse against the transferring bank would be regarded as a permitted investment for a PIC.
- For the purposes of PIC qualification, loans may be assigned as part of a general or specific assignment without the need to re-record the underlying mortgage. Whether such re-recording is required for any other purposes under the law is beyond the scope of this publication.

D. Use of Name of Bank by PIC Personnel

A PIC may use the name of the lending bank. However, a PIC must have a verifiable code or other means of identification in order to properly identify PIC transactions.

E. Documentation

All transactions between a financial service company (or one of its affiliates) and a PIC should be documented. For example, if the PIC is to lease space or share costs with a related person, a written lease or cost-sharing agreement, or both, should evidence such transactions. Such agreement need not specify which expense allocation method shall be employed by the parties, so long as the method actually employed meets the requirements set forth in this section.

ACCOUNTING/TAX ISSUES:

A. Annual Information Return/Statute of Limitations

A PIC will be required to file an annual information return, **Form CT-1120 PIC**. The filing of such return will start the running of the statute of limitations relating to possible deficiency assessments.

B. Adjustments Pursuant to Conn. Gen. Stat. §12-226a

The commissioner will not exercise his discretion to make adjustments under Conn. Gen. Stat. §12-226a either: (a) on the transfer of a loan (and the resulting future income stream) by a financial service company to a PIC, while the financial service company maintains the burden of the interest expense and other costs associated therewith, or (b) on the transfer of a bad loan by a PIC (and potential loss) back to the financial service company which originated the loan. However, the commissioner reserves the right to reallocate other expenses, costs, and items of income if: (1) the “safe harbor elections” for allocation of expenses and costs are not used, and (2) the method used is determined by the commissioner to require reallocation in order to properly reflect the activity, business, income or capital to Connecticut.

C. PIC Disqualification

A PIC will be disqualified if it engages in prohibited activities (see page 2). Such PIC may requalify as a PIC in a subsequent taxable year if it ceases to engage in prohibited activities.

D. Related Expenses for Dividends from PIC

No add-back of expenses related to dividends from a PIC is required.

REGISTRATION: A PIC is required to register with the Department of Revenue Services by completing **Form REG-1, Application for Tax Registration Number**. For additional information, call the Department’s Registration Unit at 860-297-4885.

EFFECT OF THIS DOCUMENT: A Special Notice is a document that announces a new policy or practice in response to changes in State or federal laws or regulations or to judicial decisions. A Special Notice indicates the Department’s informal interpretation of Connecticut tax law and may be referred to for general guidance by taxpayers or tax practitioners.

FOR FURTHER INFORMATION: Please call the Department of Revenue Services during business hours, 8:00 a.m. to 5:00 p.m., Monday through Friday:

- **1-800-382-9463** (toll-free within Connecticut), or
- **860-297-5962** (from anywhere)

TTY, TDD, and Text Telephone users only may transmit inquiries 24 hours a day by calling 860-297-4911.

FORMS AND PUBLICATIONS: Forms and publications are available all day, seven days a week:

- **Internet:** Preview and download forms and publications from the DRS Web site: **www.drs.state.ct.us**
- **DRS TAX-FAX:** call **860-297-5698** from the handset attached to your fax machine and select from the menu
- **Telephone:** call **860-297-4753** (from anywhere), or **1-800-382-9463** (toll-free within Connecticut) and select **Option 2** from a touch-tone phone